**IASB/FASB Meeting**
**Week commencing 21 March, 2011**

IASB Agenda reference **10E**

Staff Paper

FASB Education Session
March 17, 2011

FASB Agenda reference **140E**

Project **Revenue Recognition**

Topic **Uncertain consideration – constraining revenue**

## Purpose and summary of staff recommendations

1. This paper considers whether and how an entity should constrain the amount of revenue recognized when the customer promises an uncertain amount of consideration.
2. IASB Agenda Paper 10D/FASB Agenda Paper 140D addresses how to measure the transaction price. This paper addresses when to limit the amount of the transaction price that an entity recognizes as revenue.
3. This paper does not address disclosures associated with uncertain consideration. That topic will be discussed at a future meeting.
4. The staff recommends the following:
   - (a) The revenue standard should require a constraint on the amount of cumulative revenue recognized to date rather than on the amount of consideration allocated to all performance obligations;
   - (b) The amount of cumulative revenue recognized to date should be limited to the amount that the entity can reasonably estimate. The revenue standard should carry forward most of the guidance in the

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Exposure Draft on when an entity can reasonably estimate the transaction price.

(c) The revenue standard should include implementation guidance to clarify that an entity would not recognize revenue before the uncertainty is resolved in both of the following circumstances:

(i) the amount of consideration is based on future sales of the customer's products to another party (e.g. sales-based royalties),

(ii) the amount of consideration is based on an index value in the future (e.g. a return on assets under management relative to the return of an observable index).

5. This paper is organized as follows:

(a) Background information (paragraphs 6–10)

(b) Constraining cumulative revenue recognized (paragraphs 11–18)

(c) Determining whether cumulative revenue recognized can be reasonably estimated (paragraphs 19–36)

(d) Uncertain consideration based on an index (paragraphs 37–45).

## Background information

### *Proposals in the Exposure Draft*

6. In the Exposure Draft, *Revenue from Contracts with Customers* (ED), the Boards proposed that an entity should recognize revenue in the amount of consideration the entity expects to receive from the customer in exchange for transferring goods or services. If the amount of consideration in a contract is uncertain, the transaction price would be estimated at each reporting period to represent faithfully the circumstances present at the reporting date and the changes in circumstances during the reporting period.

7. In the ED, the Boards proposed a constraint on the measurement of revenue by stating that an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. If an entity

cannot reasonably estimate the transaction price, the entity would not recognize revenue from satisfying a performance obligation until the amount can be reasonably estimated. If an entity can reasonably estimate some, but not all, of the consideration amount (for example, if part of the total consideration is a fixed amount), the Boards proposed that the transaction price allocated to all performance obligations in a contract would include only the amount that the entity can reasonably estimate.

8. The ED stated that the transaction price can be reasonably estimated only if both of the following conditions are met:
    (a) the entity has experience with similar types of contracts (or access to the experience of other entities if it has no experience of its own); and
    (b) the entity's experience is relevant to the contract because the entity does not expect significant changes in circumstances.

9. The ED also proposed factors that an entity would consider to determine whether the entity's experience is relevant to the contract:
    (a) the consideration amount is highly susceptible to external factors (for example, volatility in the market, judgement of third parties, and the risk of obsolescence of the promised goods or service);
    (b) the uncertainty about the amount of consideration is not expected to be resolved for a long time;
    (c) the entity's experience with similar types of contracts is limited; and
    (d) the contract has a large number of possible consideration amounts.

***Feedback on the Exposure Draft***

10. Most respondents agree with the Boards' proposal to constrain the amount of revenue recognized if an entity cannot reasonably estimate the transaction price. Most respondents also agreed that the final revenue standard should include factors to help an entity determine whether the transaction price can be reasonably estimated. However, respondents asked the Boards to clarify the following:

(a) Whether to constrain the amount allocated to *all* performance obligations in the contract or to only the *satisfied or partially satisfied* performance obligation(s);

(b) Whether an entity should recognize revenue using estimates when the amount of consideration is based on a future transaction or event controlled by the customer; and

(c) How an entity would determine the transaction price when the amount of consideration is based on an index.

## Constraining cumulative revenue recognized

11. Some respondents were concerned that the proposed model would constrain the amount allocated to *all* performance obligations in the contract rather than to only the *satisfied or partially satisfied* performance obligation(s) in the contract. Those respondents highlighted the following consequences of constraining the amount allocated to all performance obligations:

    (a) *Unintended effect on the onerous test*: if an entity cannot reasonably estimate the transaction price, the entity would not allocate any consideration to the remaining performance obligations in the contract. Hence, those remaining performance obligations would be deemed onerous even though the entity expects those performance obligations to be profitable.

    (b) *Pattern of revenue recognition that does not depict the entity's performance*: for some contracts, constraining the amount of consideration allocated to all performance obligations would result in a pattern of revenue recognition that does not depict the transfer of goods or services to the customer.

12. The following example illustrates the concerns of respondents:

On 1 January, an entity enters into a contract with a customer to provide fund management services for a period of one year. As payment for services, the entity will receive a quarterly fee 1% of the assets under management (AUM) of the fund at the end of each quarter. The entity determines that the contract contains one performance obligation that is satisfied continuously.

The entity concludes that its experience with similar contracts is not relevant to the contract because the amount of consideration is highly susceptible to external factors (i.e. market risk) and there is a large number of possible consideration amounts.

Under the ED, some have interpreted that revenue would be recognized over the contract period as follows:

| | Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 |
|---|---|---|---|---|
| AUM | 8,000 | 12,000 | 16,000 | 16,000 |
| Revenue recognized per quarter (CU) | 20 | 80 | 170 | 250 |
| Revenue recognized cumulatively (CU) | 20 | 100 | 270 | 520 |
| | | | | |
| Revenue calculation by quarter | | | | |
| Quarter 1 | 20[(a)] | 20 | 20 | 20 |
| Quarter 2 | 0 | 60[(b)] | 30 | 30 |
| Quarter 3 | 0 | 0 | 120[(c)] | 40 |
| Quarter 4 | 0 | 0 | 0 | 160[(d)] |
| Total | 20 | 80 | 170 | 250 |

Calculations:
(a) (8,000 x 1%)/4
(b) [(12,000 x 1%)/4 * 2 quarters]
(c) [(16,000 x 1%)/4 * 3 quarters]
(d) [(16,000 x 1%)/4 * 4 quarters]

13. Respondents think that recognizing revenue as suggested in the example above would not accurately reflect the asset manager's performance as the service is provided to the customer. Those respondents think that the revenue should be recognized when the consideration for each period is no longer uncertain. Similar concerns were raised by respondents from the hospitality industry with regard to hotel management services.

14. In addition, respondents were concerned that the contract in the example above would be deemed onerous at contract inception even though the entity does not expect the contract to be loss-making.

***Staff recommendation***

15. To address the concerns discussed above, the staff recommends clarifying in the final revenue standard that the proposed model should constrain the cumulative revenue recognized to date (i.e. to satisfied or partially satisfied performance obligations) rather than the amount of consideration allocated to all performance obligations.

16. In accordance with the staff's recommendation, the example above would be accounted for as follows:

| | Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 |
|---|---|---|---|---|
| AUM | 8,000 | 12,000 | 16,000 | 16,000 |
| Revenue recognized per quarter (CU) | 80[(a)] | 120[(b)] | 160[(c)] | 160[(d)] |
| Revenue recognized cumulatively (CU) | 80 | 200 | 360 | 520 |
| | | | | |
| Calculations:<br>(a) (8,000 x 1%)<br>(b) (12,000 x 1%)<br>(c) (16,000 x 1%)<br>(d) (16,000 x 1%) | | | | |

17. The staff thinks that the pattern of revenue recognition illustrated above is more consistent with the core principle of the proposed model. That is, it better depicts the services provided to the customer and the amount of consideration the entity receives in exchange for those services over the contract period.

18. In addition, constraining cumulative revenue recognized to date, rather than the total transaction price, would mitigate the concerns with the onerous test. An entity would perform the onerous test using its estimate of the transaction price allocated to the remaining performance obligations in the contract. That estimate of the total transaction price would not be constrained unless the entity lacks the data to estimate the amount of consideration to be received.

| Question 1 |
|---|
| The staff recommends clarifying in the final revenue standard that an entity should constrain the amount of cumulative revenue recognized to date rather than the amount of consideration allocated to all performance obligations.<br><br>Do the Boards agree? |

## Determining whether cumulative revenue recognized can be reasonably estimated

19. The first section of this paper proposes to constrain the cumulative revenue recognized to date rather than the total transaction price. This section of the paper focuses on the transaction price constraint in the ED of "reasonably estimated".

***Feedback***

20. Respondents generally supported the overall concept of having a reasonable estimate constraint. Respondents also generally agreed that the revenue standard should specify when an entity can reasonably estimate the transaction price. The following comment from a respondent is illustrative of that support:

> We agree that entities should be able to recognize revenue on the basis of a reasonably estimated transaction price. Further, we agree with the criteria proposed in paragraph 38 as the basis for determining when management would have sufficient, reliable information to make a reasonable estimate. [Comment Letter 192]

21. However, respondents were concerned with the following:

    (a) What to do when an entity has a new product offering or is a new entity (and hence has no experience with similar *contracts* but might have other evidence to support a reasonable estimate); and

    (b) What to do when the consideration received by an entity is dependent on a future transaction or event controlled by the customer (for example, usage or sales-based royalties).

***New product offerings or new entities***

22. Some respondents thought the factors/indicators in paragraphs 38 and 39 of the ED were too prescriptive. Those respondents were concerned that a new entity or an entity offering new products or services would be precluded from recognizing revenue when a transaction includes uncertain consideration. Consider the following comments from respondents:

> Paragraphs 38 and 39 are too prescriptive. They may be viewed by some to preclude recognition of variable consideration when a company is offering new products or services. [Comment Letter No. 602]
>
> The Boards should clarify how the guidance related to "experience with similar contracts" for estimating a transaction price would be applied for a new entity with no previous experience. For example, a new entity enters into its first contract with a customer and may earn a performance bonus if a delivered good meets certain performance requirements. If the results of the entity's extensive testing procedures provide a basis to reasonably estimate whether or not the good will meet those performance requirements, we believe that could provide a sufficient basis on which the new entity may reasonably estimate the variable consideration. [Comment Letter No. 418]

23. The staff recommends revising the conditions in paragraph 38 of the ED that must be met in order for the transaction price to be reasonably estimated. The staff thinks an entity should be required to have either experience (or access to the experience of other entities) or other persuasive evidence, such as evidence from extensive testing procedures, to support the estimated transaction price.

***Royalties***

24. Some respondents raised concerns with the factors in paragraph 39 of the ED. In some situations, the consideration received by the entity is dependent on the actions of the customer or a third party. For example, an entity may have the ability to reasonably estimate future royalty payments based on their experience with similar contracts. However, some respondents think that the entity should not recognize revenue until the uncertainty is resolved if the royalty payments are dependent on a customer’s subsequent generation of revenue.

25. The following comments from respondents best illustrate those concerns:

> We believe the guidance in paragraph 38 and 39 should include the restriction, consistent with ASC 926 that variable fees which are based on the future revenues generated by a customer should not be recognized prior to the customer's generation of those revenues and the customer becoming contractually obligated to pay such amounts. We believe this will enhance the quality of the estimates since they will be less dependent on a third parties actual results, eliminate the counter intuitive results of recognizing revenue before it is recognized by the customer, and eliminate the judgments around the impact of activities performed by the licensor on revenue recognition. [Comment Letter No. 350]

> The Company has concerns that these provisions on variable consideration may lead to recognition of revenue before certain of an arrangement's key contingent events are settled, particularly as those contingent activities that are dependent upon the customer's performance obligations. For example, media and entertainment companies often are able to estimate a range of a film's ultimate theatrical revenue after a certain period of time after its initial theatrical release but before it has completed its theatrical run. In accordance with the ED, a company could potentially recognize revenue before a film has completed its theatrical run. However, each company's ability to "reasonably estimate" such amounts will vary based upon its respective historical experience and relative materiality thresholds and, therefore, the timing and amount of recognition for the same economic transaction may vary significantly between companies. DWA has concerns that these issues could lead to financial information that is not meaningful to users of financial statements or lead them to make improper decisions. [Comment Letter No. 355]

> [T]he Company believes that if companies are required (and allowed) to apply significant judgment in the determination of what is reasonably estimable as well as making the estimates to recognize contingent considerations, the estimates would be subject to individual discretion and subjectivity and have questionable value to investors. This approach may lead to significant time for discussions between the reporting companies and their auditors as well as aggressive accounting in accelerating revenue upfront with potential significant reversals in later periods due to changes in estimates. This new model may lead to potential shareholder lawsuits if companies were being too aggressive and over-estimated revenue upfront. [Comment Letter No. 411]

26. Consider the following example which illustrates the concern of revenue reversals as a result of an entity using estimates in circumstances where the amount of uncertain consideration to be received is dependent on the customer’s actions:

> An entity has a non-exclusive license agreement for intellectual property with a customer on a per-unit-shipped basis for a term of 5 years. Based on the entity's experience with previous contracts, the entity estimates that 1,000 units will be shipped over the term of the contract [200 units per year]. Upon entering the contract and ignoring time value of money for simplicity purposes, the entity recognizes revenue of CU10,000 [1,000 units x CU10]. After year two, the customer decides to use a competitor's intellectual property instead of the entity's. The entity would therefore need to reverse revenue of CU6,000.

27. Also, consider the following example which illustrates the concern of revenue being recognized by an entity before the customer has an unconditional obligation to pay (and before a third party has an obligation to pay the customer):

> An entity has a non-exclusive film license agreement with a customer for a term of 2 months. Under the contract, the entity receives 50% of the ticket sales generated by the customer showing the film. The film is released on 30 December (entity has a calendar year-end). Ticket sales for the film's opening weekend on 30 and 31 December are CU70 million. Based on the entity's experience with similar contracts, the entity estimates that total ticket sales for the film under the contract will be CU200 million. For that fiscal year-end, the entity would recognize revenue of CU100 million [CU200 million x 50% share] even though actual ticket sales of the customer are only CU70 million.

28. The example above also illustrates the concern about the subsequent events period and whether the entity would need to continue to update its estimate and revise its recognized revenue based on actual experience during the subsequent events period.

29. To address those concerns, the staff recommends revising the first factor in paragraph 39 of the ED that reduces the relevance of an entity's experience with similar types of contracts. The staff recommends adding language that specifically mentions consideration amounts that are dependent on the subsequent selling or pricing activities of the customer.

30. The staff also thinks an example should be included in the final standard illustrating that a reasonable estimate cannot be developed for a sales-based royalty contract where the amount of consideration is dependent upon the future sales or performance of the customer.

31. Under the staff's proposal, the amount of revenue recognized by an entity with a sales-based royalty would be limited to the sales of the customer which the entity deems are reasonably estimable. The amount of consideration may become reasonably estimable when the entity receives a report of the performance of the customer or the entity receives payment for the benefit provided to the customer.

32. In the per-unit-shipped royalty example in paragraph 26 above, the staff thinks the entity would recognize revenue only in year one when it could reasonably estimate the number of units shipped for that year and would not record revenue in year one for all five years of the contract. The staff thinks that the entity's experience with similar contracts is not relevant to the contract because the amount of consideration is highly susceptible to factors outside the control of the entity's performance (i.e. subsequent selling activities of the customer), the uncertainty is not expected to be resolved for a long time (in the case of the later years of the contract), and there are a large number of possible consideration amounts.

33. In the film license royalty example in paragraph 27 above, the staff thinks the entity would recognize revenue in its calendar year in which the film was released of CU35 million based on its 50% share of the actual ticket sales of CU70 million, as that revenue is reasonably estimable as of the balance sheet date. The staff thinks that the entity's experience with similar contracts is not relevant to the contract because the amount of consideration is highly susceptible to factors outside the control of the entity's performance (i.e. subsequent selling activities of the customer) and there are a large number of possible consideration amounts.

***The "contingent cap" alternative method of constraining revenue recognition***

34. Some respondents to the ED suggested an alternative method of constraining revenue recognition because they think the constraint of "reasonably estimated" is not sufficiently robust for revenue recognition. Those respondents would prefer to carry forward the "contingent cap" revenue allocation guidance from Subtopic 605-25 in US GAAP. Under that guidance, an entity would limit amounts allocated to satisfied performance obligations to amounts that are not contingent on an entity's future performance.

35. Respondents who suggest this alternative constraint think that revenue should not exceed legally enforceable payments due from the customer under the terms of the contract because otherwise, an entity would recognize a contract asset representing benefits to which the entity does not presently have enforceable rights (and hence, does not meet the definition of an asset). Those respondents think that a contract asset is different from a lessor's receivable because the lessor is entitled to receive the future lease payments without being obliged to provide any future services. They think revenue should be deferred until the entity performs the services which give rise to the right to receive consideration.

36. The contingent cap constraint is supported primarily by companies in the telecommunications industry. The staff thinks that the constraint would not be appropriate when applied to other industries. For example, in many services contracts (including construction), it would be appropriate to recognize revenue as services are provided even though the amount of consideration is contingent on the entity's future performance. Although the staff thinks that the contingent cap constraint is too strict as a concept for the revenue standard, the staff will consider further the implications of the revenue model on the telecommunications industry.

***Staff recommendation***

| **Question 2** |
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| The staff recommends that the final standard should:<br><br>a) carry forward most of the guidance in the ED on when an entity can reasonably estimate the transaction price (subject to the drafting suggestions discussed in paragraphs 23 and 29 of this paper), and<br><br>b) include implementation guidance to clarify that an entity would not recognize revenue before the uncertainty is resolved when the amount of consideration is based on future sales of the customer's products to another party (e.g. sales-based royalties).<br><br>Do the boards agree? |

## Uncertain consideration based on an index

37. Some respondents requested clarification on whether an amount of consideration calculated by reference to an index can be reasonably estimated in accordance with the ED.

38. When developing the ED, the Boards noted that typically an entity would not be able to reasonably estimate an amount of consideration that is based on an index value in the future. Hence, Example 18 of the ED suggested that an entity would not be able to reasonably estimate the transaction price for an asset management incentive fee that is based on an index value at the end of a year.

39. Example 18 from the ED is as follows:

> On 1 January, an entity enters into a contract with a client to provide fund management services for one year. The customer is required to pay a fixed quarterly amount plus 10 per cent of any increase in the fund's value relative to an observable index at the end of the year.
>
> The entity has entered into many similar contracts previously. However, the entity determines that its experience with those types of contracts is not relevant to the contract because the circumstances surrounding those types of contracts could change significantly. The variable consideration amount is highly susceptible to external factors (market risk), the uncertainly is not expected to be resolved until the end of the

> year, and the contract has a large number of possible consideration amounts.
>
> Hence, the transaction price would be limited to the fixed amount of consideration until the end of the year.

40. Some respondents were concerned that the example in the ED would preclude, in all circumstances, an entity from recognizing revenue when the amount of consideration the entity receives is based on an index value. Those respondents think that a current index value might be a reasonable estimate of the amount of consideration to be received and would result in a pattern of revenue recognition that better depicts the entity's performance. In addition, those respondents note that recognizing revenue by reference to a current index value is an acceptable method in US GAAP (Section 605-20-S99 on accounting for management fees based on a formula).

41. The guidance in US GAAP suggests that an entity would recognize revenue by reference to a current index value only if the contract is cancellable and the customer would be obliged to pay an amount of consideration based on the index value at the date of cancellation.

42. Consider the following example:

> On 1 January, an entity enters into a one year contract with a customer to provide fund investment management services. As part of the contract, the entity will receive a performance-based incentive fee of 10 per cent of the fund's return in excess of the return of an observable index at the end of the year.The contract is cancellable by either party with reasonable notice at the end of each quarter. If the contract is cancelled, the incentive fee would be calculated at the cancellation date based on the fund and index returns to date.
>
> At 30 June, the fund's value is CU1,000 in excess of the observable index. Hence, the entity would have the right to receive CU100 (CU1,000 × 10%) from the customer.

43. The fact pattern in the example above is different from the fact pattern in Example 18 of the ED. The difference is that the contract is cancellable by either party and, if cancelled, the customer would be obliged to pay an amount of consideration based on the index value at the date of cancellation. In that fact pattern, the staff thinks there are two possible accounting methods:

(a) *Method 1: No incentive fee revenue until the end of the year*—Under this method, an entity would conclude that it cannot reasonably estimate the amount of consideration for the incentive fee because that amount is based on a factor outside the entity's control (i.e. a future index value). The entity would account for the contract assuming it will not be cancelled. Effectively, the contract would be accounted for consistently with Example 18 of the ED.

(b) *Method 2: Estimate revenue throughout the year using the current index value*—Under this method, an entity would conclude that it has a right to an amount of consideration throughout the year because of the cancellation provisions of the contract. Hence, recognizing revenue throughout the year would depict the entity's performance to date at the amount of consideration the entity expects to receive in exchange for that performance. (Note: revenue could be negative in a reporting period.)

44. Under Method 1, the entity in the example in paragraph 42 would not recognize any revenue for the incentive fee until the end of the year. Under Method 2, the cumulative amount of revenue recognized by 30 June would be CU100.

45. In practice, the staff understands that most contracts similar to the one in paragraph 42 are accounted for using Method 1, which is the preferred method in US GAAP. Method 1 also is consistent with the accounting for incentive fees in most other services contracts (e.g. a performance bonus paid to an entity based on the entity achieving a specified service level). However, the staff notes that the cancellation provisions of services contracts in other industries often differ from the above example in that an incentive fee would not be owed to the entity based on a current index value if the contract were cancelled.

| **Question 3** |
| --- |
| The staff recommends that if an entity receives an incentive fee based on an index value in the future, the entity should account for the incentive fee using Method 1 described in paragraph 43 of this paper.<br><br>Do the boards agree? |